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ELEMENTARY ECONOMICS

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VOLUME II
Fourth Edition

THE MACMILLAN COMPANY
NEW YORK 1939

Printed in the United States of America.
Set up and electrotyped. Published May, 1939.

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TAXATION AND THE BUSINESS OF GOVERNMENT

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PRINCIPLES OF GOVERNMENT INCOME

Government and the economic organization. No account of the economic organization would be complete without attention to the part played by government[1] in the production, distribution, and consumption of wealth. The existence for government is familiar to everyone, and virtually everyone recognizes its necessity. In fact we incline so much to take government for granted that it may not be amiss to lay the foundation for the study of this part of our subject by noting very briefly some of the more important economic aspects of government.

In modern times the greatest consumer of goods and services is the government. In 1936 the economic activity of the people of the United States brought forth a total income which is estimated as worth 65¼ billion dollars. The government (including all grades, federal, state, and local) collected and expended something over 17 billions, about 26 per cent of the total national income. In taxes alone there were collected 10½ billions. In the prosperous year 1929, when the national income was estimated at 79½ billion dollars, government collected and expended 11⅔ billions.[2]

On the side of production, the government is ever present. For example the United States Post Office furnished services in the fiscal year ending June 30, 1938, which cost over seven hundred and seventy-six million dollars. In this same year the Tennessee Valley Authority cost 42 millions, and the Panama Canal, 11 millions; on public works the federal government spent the huge sum of 1,849 millions. But the chief contribution of government to production is

[1] The term "government" is used in this book to include all grades of government of any particular community, for example in the United States of America the federal government, the state governments, and the governments of counties, towns or townships, cities, school districts, and all other political jurisdictions. It is rather common in popular speaking and writing to refer to the United States federal government as "the government" in distinction from the states and the local jurisdictions. The term is not so used in this book.

[2] United States Census, *Financial Statistics of State and Local Governments, 1932*, 1935; National Industrial Conference Board, *Cost of Government, 1935–1937*, 1938.

indirect, consisting in such services as protection from outside foes, enforcement of law and order among the people, promotion of the public health, public education, etc.

In the field of distribution, the government is no less omnipresent and important. We need only to recall that in the year 1936 over one-fourth of the total income of the American people was collected and redistributed by government. In the year 1936 the various governments in the United States (federal, state, and local) paid nearly 6 billion dollars in compensation to 3,625,000 employees, not including work relief employees.[1] These employees comprised almost 9 per cent of all persons employed in the country (not including unpaid family labor).

The functions of government. Lest they be overlooked in the discussion of the more specialized and controversial governmental activities, a brief summary of the normal functions of government may not be out of order. The primary functions of government include (1) those of a defensive nature: defense against outside foes, requiring army, navy, etc.; justice and security, afforded by police service, courts, and penal institutions; regulation of private industry, in particular monopolistic industries like the railroads and those which are so complicated as to be only imperfectly understood by the public, such as the banks and insurance companies; protection against disease and accident; maintenance of moral standards; and protection against fire, storms at sea, and certain other forces of nature; and (2) developmental functions: education; religion; facilities for private industry, especially highways and bridges, harbors, the monetary system, information services, etc.; and development and conservation of the nation's natural resources. In addition to the foregoing, which are peculiarly governmental functions in modern times, government may enter the industrial field, where private enterprise generally holds sway, and we have a considerable variety of government industries.

Government income. To meet the heavy expenditures necessitated by the performance of its functions, the modern government

[1] United States Bureau of Foreign and Domestic Commerce, *National Income, 1929–1936*, 1937. For further light on this topic, cf. William E. Mosher and Sophie Polah: "Public Employment in the United States," *National Municipal Review*, January, 1932, pp. 51–75.

must have an equally large income. In modern times there are just four important sources from which government income is to be obtained and which now demand our study. These are (1) industrial earnings (prices), (2) taxes, (3) fees and assessments, and (4) loans.[1]

The finances of government industry. When a government engages in a business enterprise, such as the United States Post Office or the water supply system of a city, it sells its product (goods or service) at a definite price to the consuming public much as any private business concern does. The citizen may take the offered service or not as he wishes, and if he does not take it he makes no payment. Payment is voluntary and in proportion to the amount of the service received. For example the government offers, through the post office, to transmit letters and parcels. If the citizen chooses to take advantage of this service he pays the stated price; otherwise he pays nothing to the post office. In these respects government industry is similar to private business.

In contrast with the private entrepreneur, the government's purpose in its industrial undertakings is ordinarily, not the making of a profit, but the furnishing to the people of a service which it is believed can be better provided by the government than by private enterprise. Thus the post office exists, not to make profits for the government, but to afford the people facilities for the widespread communication of messages and information and the cheap and easy transmission of merchandise in a manner which it is believed could not be obtained from private agencies.

In general, governments seek to make their industrial enterprises pay their way; prices are fixed so that the receipts shall just about equal the expenditures in each particular industry. There are, it is true, many exceptions. Sometimes a government reserves for itself a monopoly of a certain business and runs the industry frankly for the sake of making a profit for the public treasury. The French tobacco monopoly is an example. This result is scarcely possible unless the government enjoys a monopoly position; other-

[1] For the sake of completeness and to avoid possible misunderstanding it may be well to mention certain minor sources of government income, whose investigation the limits of this book will preclude. The most important of these are: gifts, forfeiture, reversion, escheat, indemnity, confiscation, fines, and penalties.

wise the competition of private business firms will prevent the government industry from securing a profit. On the other hand, some government industries do not secure revenues sufficient to meet their expenses, thus showing a deficit, which has to be made up out of the general treasury. The United States Post Office is regularly in this state. In any event each government industry yields industrial earnings which are earmarked to meet the expenses of that particular industry.

Financing the primary functions of government: General character of revenue. If now we pass from its industrial undertakings to the primary functions of government, we shall find certain differences in their financing. The primary functions, such as defense, justice and security, protection against disease, education, etc., are undertaken by the government in order to benefit the people as a whole, without the purpose of giving particular benefit to particular individuals. For example the state and local governments of the United States provide public schools and universities, at great expense, not primarily in order to benefit those persons who want an education for themselves or their children, but because it is believed that a prosperous and enduring democracy is not possible unless there is widespread education among the people. Education is provided therefore to benefit the whole people, not for the sake of those particular individuals who attend the public schools.

In all these cases therefore no attempt is made to pay the cost of the service by charging a price and so collecting from each citizen in proportion to the benefit he has received. The government does not sell education as it sells postal service; education is offered freely to all. A may have one child in the public school, while B has half a dozen. No account is taken of these facts in determining the respective amounts which A and B shall pay toward the support of the schools. Furthermore no citizen is able to avoid support of the public school by declining to avail himself of its services. C may send all his children to private schools and there pay for their education, and D may have no children at all. Neither will find it possible to cite these facts as reasons why he should not contribute to the cost of the public schools. The burden of furnishing the money necessary to pay the cost of public education, as of the other

primary functions of government, is distributed among the people according to certain rules, which we shall presently study, but there is no necessary relation between the amount of any person's contribution and the service received by him, nor may any person avoid contributing by declining to avail himself of the government's service. Contribution toward the cost of the primary functions of government is compulsory.

It follows that no attempt is made in the case of the primary functions of government to obtain in connection with each function a revenue earmarked to meet the expenditures of that particular function. As a general rule, little or no revenue comes in to the government in connection with the performance of any particular function, and the bulk of the revenue is received without any reference to the particular functions of government for which it is to provide.

Taxes. The foregoing analysis of the purpose of the government's primary functions and the financial contrast between such functions and the government's industrial undertakings has introduced the principal characteristics of taxation; namely, (1) compulsion, (2) devotion to the general welfare, and (3) apportionment without reference to individual benefit. It will be found helpful to have a precise definition of a tax, for which the following will satisfactorily serve our purpose: *A tax is a compulsory payment by a person to the government, destined to defray the cost of government services performed for the common benefit, and paid without reference to individual benefit.* It is upon taxes that modern governments principally rely for obtaining the money necessary to defray the cost of performing their primary functions, and taxes make up the bulk of the income of most modern governments.

Fees. The primary functions of government are performed, as has been shown, for the common benefit. Nevertheless it often happens that, in performing its primary functions, the government incidentally and unavoidably gives special benefits to particular individuals. Consider for example the granting of patents for inventions. The purpose of this service of government is not to give a special benefit to the inventor; if such were its purpose it would be a case of favoritism, repugnant to the spirit of democratic gov-

ernment. The real purpose of the patent is to promote the public welfare by encouraging the discovery and disclosure of useful new devices and by offering inducement to capitalists and entrepreneurs to develop and market them. It is for this reason that the inventor is given for a time a privileged position of monopoly with respect to his discovery. Nevertheless this is a material benefit conferred upon the inventor, and for that reason the government imposes upon him a special charge, justified by and — somewhat roughly it must be confessed — related to the particular benefit which he is presumed to have received. Such a payment is called a fee.

Fees arise also from somewhat different circumstances. There are certain occupations which cannot be left to the free and unrestricted operation of all persons without danger to the public interests. Such are the businesses of banking, insurance, taxicab operation, peddling, etc. Now the performance of this regulatory function necessitates government expenditure, and the person who chooses to enter such an occupation is thereby causing expense to the government. The government therefore charges such person a fee, covering part or all of the cost imposed upon it by his engaging in the regulated occupation. Fees are thus imposed upon those who engage in any activity over which some government regulation has been found necessary. One cannot drive an automobile, or own a dog, or enter the marriage state, without a government license, and in each case he is charged a fee to cover the cost which his act has imposed upon the government.

We now have in mind the nature of the fee, which may be defined in precise terms as follows: *A fee is a payment by a person to the government on account either of a special benefit received from the government or a special cost imposed upon the government in connection with a government service performed for the common benefit.*

Special assessments. Suppose that the city authorities decide to pave a certain street. There will generally result a material advantage to the owners of land fronting that street on account of the rise in the value of such land. The same rise in land values follows the introduction of a sewer system, street curbs, sidewalks, and other improvements. The city government undertakes a new street pavement, not from any desire to benefit particularly the owners of the

land, but because the interests of all the people of the city will be promoted by a better surface on that street. Here then is a perfect occasion for a fee and, in America at least, a fee is usually charged, which is none the less a fee in spite of its common designation as a *special assessment.* This is the definition: *A special assessment is a particular kind of fee, imposed when the special benefit consists in an enhancement of the value of land.* The amount of the special assessment may be anything up to the total addition to the value of the land caused by the government improvement. The special assessment furnishes a most interesting example of the fee, since there is here usually an attempt to relate the amount of the payment to the value of the special benefit conferred much more closely than in the case of fees in general.

Names may be misleading. In distinguishing prices, fees, and taxes, we must have regard to their real nature and not be misled by mere names. For example a fee is never greater than the value of the special benefit received or the special government cost occasioned by the fee-payer. If this limit is exceeded the payment is, at least to the extent of the excess, a tax. This is usually the case with the automobile operator's "license fee" collected by the states of the United States. On the other hand, consider the tax upon gasoline, which has come into recent prominence in the United States. This tax is imposed by the state at so many cents per gallon, and the proceeds are devoted chiefly to the maintenance and repair of the highways. When the facts are thus, this so-called "tax" is really a fee. It is a payment which may be justified either on account of the benefit received from the public highways or the cost imposed by wear and tear upon the highways, and it apportions with reasonable accuracy the size of the payment to the amount of such benefit or cost.

Distribution of the tax burden: Equal distribution. Almost the entire revenue required to meet the cost of government's primary functions comes in the form of taxes, which are exacted from the people with little or no regard to particular benefits received. Great importance therefore attaches to the distribution of the tax burden; that is, the determination of how much each person must pay for support of the general services of government.

It may perhaps serve to clarify the first steps of the investigation of this problem if we stop for a moment to consider the possibility of equal distribution. This will be recognized as the rule which usually determines the contributions of the members for support of the general services of an ordinary club. Let us see how it would work in the United States. The total tax bill of the people of the United States in the year 1936 was about ten and a half billion dollars. With a population of about 128 millions, the share of each person — man, woman, and child — would be about eighty-two dollars. At this rate a family of five (father, mother, and three children) would have an annual tax bill of $410. If the man's wages or salary and other income were $1,000, his tax bill would be over two-fifths of his income. Another family of five with an income of $10,000, in paying the same amount, would pay only about one twenty-fifth of their income, while the very wealthy would find their tax burdens quite insignificant. To the very poor the burden would be absolutely crushing, if indeed they were able to pay at all.

Now quite apart from any question of justice, it is evident that this rule would be unworkable, since there are large numbers of the people who could not possibly pay at the rate of eighty dollars a year for each taxpayer and all those dependent upon him. And whatever one's standard of justice may be, it is safe to say that virtually everyone would condemn this plan as flagrantly unjust. The important conclusion is that public opinion tolerates — even demands — a plan of tax distribution which makes some persons pay more than others. Having cut loose from the base of equal distribution, what shall be our rule of apportionment?

Benefit or cost. There have been those who believed that the costs of government should and could be distributed on the basis of the benefits received by the individual members of the group, or on the somewhat similar basis of the cost to the government of the service rendered to each person. These are in general the rules that determine prices charged in business dealings, and we have seen that they apply also to industrial enterprises conducted by government. But when we come to the general services of government, performed for the common good rather than for the particular bene-

fit of individuals, there is generally no way of measuring either the benefit or the cost to each person. How should we apportion to each citizen of the United States the benefit received by him from the activities of the army and the navy? What has the Supreme Court of the United States done for him? What part of the President's salary should he pay on the basis of benefit received? What part of the cost of the United States navy is imposed upon it by a peaceful and law-abiding Illinois coal miner who has never been outside his home state? And if it cost the navy and marines half a million dollars to save a citizen who fell into the clutches of a tribe of bandits, shall he be made to pay the cost? And if he be a poor man, shall he be protected only to the extent of his ability to reimburse the government for the cost? Even were there some ascertainable relation, the government could collect only from those who were able to pay, though its general services must be rendered for all without discrimination.

It should be clear that neither benefit nor cost can serve as a general rule for the apportionment of taxes. At the same time these principles need not be discarded entirely. Just as they serve well as the bases for fees and assessments, so they have a certain bearing at least upon the obligation to pay taxes, if not upon the amount of the individual contribution. This will come up again in our study of particular taxes.

Ability to pay: Meaning. The almost instinctive rejection of the plan of equal distribution of the tax burden is based upon the common feeling that those who have much should pay more than those who have little, that there should be at least some approach to equality of sacrifice, that people should pay taxes in proportion to their ability to pay. There is no doubt a lack of precision in these notions, but they are widely held and with sufficient clearness to indicate another rule for tax apportionment; *i.e.*, the principle of ability to pay, which may be paraphrased accurately enough as the principle of equal sacrifice.

It is not our purpose to undertake a philosophical analysis of the principle of payment according to ability; its broad meaning will be clear enough for our present purpose. As so understood, the ability principle has on the whole commended itself to modern students of

taxation and to modern public opinion as the basic principle of tax apportionment, to be supplemented by the principles of benefit and cost so far as they may be applicable and to be modified on occasion by other principles of a non-fiscal character. It must never be forgotten however that the complex practical problems of taxation are not to be solved by the mechanical application of any set of general principles. Modifications of general rules and resort to other principles will be found necessary to meet the exigencies of particular kinds of taxes.

How is the ability to pay measured? The collection of taxes being a practical financial operation, there is necessity of a financial yardstick with which to measure taxpaying ability. For all practical purposes, just three measures are available: (1) the possession of wealth (or property), (2) the receipt of income, (3) consumption, or expenditure. We may fairly assume that to the student who has reached this point in the study of economics the appropriateness of these measures will be evident.

In the application of the property and income yardsticks to the measurement of taxable ability, it is generally the net amount, rather than the gross, that more accurately measures taxpaying ability. A and B may each own wealth of a value of $50,000. If A has debts of $30,000, representing property rights of others against him and his wealth, while B has no such claims against him, it is evident that the taxpaying abilities of the two, so far as indicated by wealth or property, are not the same, and that A's ability is to be measured by his net possessions of $20,000. Speaking strictly and as we have previously defined the terms, it is not wealth, but net property, that is the real measure. Net property is the difference between all the taxpayer's possessions (including property rights against the wealth and persons of others) and the property rights of others against him and his wealth. Likewise in using the income measure, it is net income; *i.e.*, the difference between gross income and the expenses necessary to secure such income, that is the real measure of taxable ability.

Proportional taxation. There arises at once the question whether the relation between wealth, income, or consumption and taxable ability is one of simple proportion or is something different. Sup-

pose that A has a net income valued at $2,000, while B's is worth $4,000, and C's, $40,000. Does this indicate that B should pay twice as much as A, and that C should pay ten times as much as B and twenty times as much as A? If so we have proportional taxation, to be accomplished by a uniform rate. Suppose the rate is 4 per cent. Then we have this result, in which the tax payments are in direct proportion to the respective net incomes:

Person	*Net income*	*Tax rate*	*Amount of tax*
A	$ 2,000	4%	$ 80
B	4,000	4%	160
C	40,000	4%	1,600

Progressive taxation. If instead of making the tax payments directly proportional to the base, they are made to increase at a rate faster than the increase in the base, we have progressive taxation. For example suppose a scheme of income tax rates such as this:

On the first $1,000 of net income	1%
On the part of the net income:	
over $ 1,000, up to and including $ 2,000	2%
over 2,000, up to and including 3,000	3%
over 3,000, up to and including 5,000	4%
over 5,000, up to and including 10,000	5%
over 10,000, up to and including 20,000	6%
over 20,000, up to and including 40,000	7%
over 40,000, up to and including 60,000	8%
over 60,000, up to and including 80,000	9%
over 80,000, up to and including 100,000	10%
over 100,000	11%

Now A, with a net income of $2,000, will pay a tax of 1 per cent of his first $1,000 plus 2 per cent of his second $1,000; *i.e.*, $10 + $20 = $30. Similarly B's tax would be calculated thus:

1% of the first	$1,000,	$ 10
2% of the second	1,000,	20
3% of the third	1,000,	30
4% of the fourth	1,000,	40
Total tax on	$4,000,	$100

C's tax would amount to $2,390. These results may be tabulated thus:

Person	*Net income*	*Tax rate*	*Amount of tax*	*Ratio of tax to net income*
A	$ 2,000	1%–2%	$ 30	1.5%
B	4,000	1%–4%	100	2.5%
C	40,000	1%–7%	2,390	5.975%

Under such a set of rates, B's tax would be more than three times that of A, though his income is only double A's. C's income is twenty times A's, but his tax is practically eighty times as great. This is the result of progressive taxation and is accomplished, be it noted, by giving up the uniform rate in favor of a rate which increases with increases in the base.

It is probably not possible to prove scientifically that progressive taxation is required by the principle of ability. For that we should need a calculus for the measurement of sacrifice which thus far does not seem to have been discovered. However there is little doubt that the consensus of modern opinion, expert and general, inclines to the support of progression.

If there is no scientific proof of the correctness of progressive taxation, still less can there be any scientific determination of the exact scale of progressive rates required to apply the ability principle. In actual legislation the rates of progressive taxes are determined principally by rule of thumb, guided by various principles and interests, harmonious or conflicting. This is a matter to which we shall later return.

Regressive taxation. It is possible to apply a principle opposite to progression, by fixing rates which decrease as the tax base increases. This is called regressive taxation. There are few if any who defend this rule as an accurate application of the ability principle, and it never appears consciously embodied in tax legislation.

The problem of taxing according to ability. There is no one perfect yardstick for the measurement of taxpaying ability. A general property tax which reached the entire net property rights of every natural person would be an accurate measure so far as it went. It would be defective in that it would fail to take account of the ability obviously conferred by the receipt of income from other sources than property, such as salaries, professional fees, and wages. Suppose that A and B each owns property (corporate securities, let us say) yielding an annual income of $5,000 and worth $125,000 and that, while A has no other income, B is a lawyer earning $10,000 in fees. Obviously a property tax alone, exacting equal contributions from A and B, would miss widely the mark of taxation according to ability.

On the other hand, the commonly held notion that income is the one perfect measure of taxable ability can easily be shown to be erroneous. Suppose C and D each to be possessed of $1,000,000; C invests in corporate securities yielding an annual income of $40,000; D invests three-fourths of his fortune in idle real estate and derives only an income of $10,000 from the remaining $250,000 invested in corporate securities. The income tax alone will obviously fail to reach the taxpaying ability of D. And it is no sufficient answer to point out that if D's real estate venture proves successful, he will eventually have an increased income, upon which he will be taxed. The venture may prove unsuccessful. And in any case D is not today contributing to the present cost of government according to his ability. Each of these men was free to invest his fortune as he chose. Assuming neither to have any other source of income, their taxpaying abilities before they made their respective arrangements were equal. In this case the property tax would come closer to apportioning taxation according to ability to pay.

Consumption taxes likewise furnish only an imperfect measure of taxpaying ability. A general consumption or sales tax obviously takes more from the rich than from the poor and so recognizes the principle of ability. But such a tax alone is a very imperfect device for reaching taxpaying ability. It fails to reach the ability represented by property that is not yielding a present income (as in the case of D), and even when there is income, it fails to take account of that part of the income that is saved. Suppose E and F are neighbors with about the same needs and the same scale of expenditures, each spending around $3,000 a year, although E's income is $6,000 while F's is $3,000. E's taxable ability is double that of F — if not more — and is clearly not reached to its full extent by a tax on consumption or spending, which takes only the same amount from him as from F.[1] The relation between tax payment and ability is still more remote when the consumption tax is, as is usual, levied upon a selected list of commodities or services instead of upon all expenditures.

[1] It may be noted that, if income be defined strictly as the actual benefits or services rendered by wealth or free persons (cf. Chapter I), savings are not a part of net income, and the income tax also would fail to reach the full taxpaying ability of E.

The three measures of taxpaying ability differ as to their adaptability to progression. Consumption taxes are seldom imposed directly upon the consumer; they are usually levied against manufacturers and dealers, through whose hands the goods pass. It is impossible in such case to use progressive rates in relation to the total consumption of the individual consumer. Even where the tax is imposed directly upon the purchaser, as in some of the recent state sales taxes, it would be impracticable to use progressive rates. The property tax might conceivably be progressive. But there are serious difficulties, both theoretical and practical, and the property tax is virtually always a proportional tax. It is only the income tax that lends itself readily to progression.

In discussions of the problem of tax apportionment, use is often made of somewhat different concepts of progressive and regressive taxation. According to such concepts, taxation is considered progressive when the amount paid by the individual increases at a rate faster than the increase in some assumed general or composite measure of economic power; roughly "the tax bears more heavily upon the rich than upon the poor." In this sense the progressive income tax (even the proportional income tax with its ordinary exemptions, credits, etc.) is progressive. So to a degree is the property tax. In the first instance this tax generally falls lightly or not at all on the poor. However as will appear more clearly after our study of shifting and incidence in the next chapter, a part of the ultimate burden of the property tax is passed on to many who do not pay the tax directly. Consumption taxes, on the other hand, are considered regressive (even though they are imposed at uniform rates), because, in the first place, they are usually levied upon articles of wide general consumption which call for a greater share of the poor man's expenditure than of the rich man's, and secondly they impose no burden on that part of income which is saved, a feature of which the poor can take only slight advantage. This concept of progression, though lacking in precision, is useful when passing judgment upon a tax system.

Benefit, cost, and ability. General and special business taxes, measured more or less accurately by the amount of business done or the amount of business profits received, are quite common. Such

taxes are well known in Europe. In America they are found in the business license taxes of many of the states, particularly in the South, in the liquor licenses commonly imposed by towns and cities, and in most of the special taxes on corporations. When imposed in addition to, not in lieu of, the regular taxes upon either the property or the income of the business enterprise or upon the owner on account of the property employed in the business or the income derived from it, business taxes can with difficulty be related to the principle of ability, but must generally be frankly acknowledged as applications of the benefit or the cost principle. The assumption is that government gives special protection to property employed in business and special services to those persons, natural or corporate, so engaged, or that the cost of government is especially increased on account of business activities of the people.

The poll tax, being usually a uniform contribution from all individuals, has no relation whatever to ability, but is related to the benefit principle, on the somewhat dubious theory that protection of life is granted to all and is of equal value to all.

The fact that business taxes, poll taxes, and possibly certain other forms of taxation are not in full harmony with the principle of ability is not to be taken as an *a priori* condemnation of such taxes, but is rather an indication of the truth of our earlier statement that no one principle can be relied upon to shape all the taxes which any government finds it necessary to impose. It must further be remembered that we cannot pick out a single tax from a tax system and criticize it as though it stood alone. Final judgment must be upon the tax system as a whole. Thus it is possible to combine certain taxes measured according to benefit or cost with other taxes measured according to ability, as well as to combine proportional consumption taxes with progressive income taxes, inheritance taxes, etc., in such manner that the whole tax system may have reasonable conformity to the principle of ability.

Lawful escape from taxation. No one likes to pay taxes. It is only human nature that every taxpayer should use all lawful means to make his taxes as light as possible and that some taxpayers should resort to measures that are not lawful. Certain modern

taxes, such as the property tax, the income tax, and the inheritance tax, are so involved with complexities that it is often difficult for the taxpayer to know just what his legal obligation is. For example there can be no doubt that, under the United States income tax, many persons are paying more than their lawful taxes, through misunderstanding of the law or mere carelessness. Under such circumstances the use by some taxpayers at least of every lawful means, including the employment of tax experts and lawyers, in order to avoid paying more than is legally due, is inevitable. Again a person may escape a heavy tax upon his property by selling his real estate and moving to another town where the tax rate is lower, or a man may avoid an inheritance tax by giving his property to his intended heirs during his lifetime. Finally it is often possible to shift the burden of a tax to other persons through increasing the price charged for some commodity or service. Put in general terms, it may be possible to escape a tax burden that might otherwise have to be borne (1) by exercising care not to pay more than is legally due, (2) by putting one's self in such position that the tax law is not applicable, or (3) by using the power which a tax may give to raise the price of something sold.

Now so far as all of these expedients are legal, it can raise no ethical controversy to assert that they are entirely justifiable. For the first the legislature itself is principally responsible, through enacting tax laws too complicated or obscure for the understanding of the ordinary individual. In the second case, if it appears that taxpayers are finding it easy so to adjust their residences or businesses or possessions or other circumstances as to put themselves outside the application of a tax, thus defeating the purpose of the law, that again must be due to defects in the tax itself, for which the lawmaking body alone is responsible. The case of shifting the burden to others may indicate either failure of the law to place the final burden upon those whom the legislature intended to reach or simply the result foreseen and intended by the legislature. If the first, then the miscarriage is not to be ascribed to any dereliction, legal or moral, on the part of the taxpayer, but simply to lack of understanding of economic laws on the part of the lawmakers. As to the second, we have the simple and common case of indirect

taxation, which will be examined presently, but which requires no further comment in this connection.

In popular discussion there often appears a certain failure to distinguish between such legal and proper escape from the burdens of taxation and the evasion of taxes legally due. However much this popular confusion may be excused by the obscurity of tax laws and the complexities of the whole modern tax situation, the student must always keep the distinction in mind. Escape from taxation may be lawfully accomplished in a variety of ways; the term "evasion" had better be reserved for violations of the tax laws.

Tax evasion. When tax evasion occurs in sporadic instances, the situation is similar to any other case of violation of law and is of no special concern to the economist or the tax student. When, as is sometimes the case, there is wholesale evasion, the responsibility must be either upon the legislature for enacting a law incapable of enforcement or upon the administrative personnel. To ascribe it to a low state of public morality does not face the problem. The legislature has to deal with human nature as it is and is responsible for enacting laws which can be enforced and for providing the necessary machinery for efficient administration. We shall find instructive applications of these various principles when we come to the study of the different kinds of taxes.

The shifting of taxes: Meaning. Taxes are *shifted* when the person upon whom the tax has been imposed finds that the presence of the tax has given him the power, which he did not before possess, to raise the price of some commodity or service which he has for sale, thereby reimbursing himself in whole or in part for his tax payment and to that extent passing the burden on to someone else. An example familiar to everyone is the United States internal revenue tax upon the manufacturers of tobacco products. A comparatively heavy tax is thus imposed, but the manufacturers, who are the immediate taxpayers, regularly pass the burden of the tax on to the consumers of tobacco through an increase of the price. The degree of shifting which is possible varies, according to the nature of the tax, all the way from those whose burden is entirely or almost entirely shifted, such as the tobacco tax just cited, to

those whose shifting is impossible, such as a tax upon monopoly profits or upon economic rent. Shifting and *incidence* (meaning the final resting place of the tax burden) must never be overlooked when considering the problem of the distribution of the tax burden or when criticizing any particular tax. Obviously the person who finally bears the burden is more to be considered than he who pays only to shift the burden to others.

Direct and indirect taxes. Taxes are usually put into two classes according as the burden is or is not normally shifted by the one from whom the government collects the tax. Direct taxes are those whose burden remains on the whole upon those from whom the tax is originally collected. Indirect taxes are those whose burden is normally shifted. Since the possibility of shifting may be present only partially and in various degrees, it is not always possible to draw a sharp exclusive line between the two classes of taxes. However the characteristics of the more important kinds of taxes are so clearly marked that there is usually little difficulty in placing any given tax in its proper class. This distinction, be it noted, is an economic one. It does not agree precisely with the legal definition of a direct tax, as laid down by the Supreme Court of the United States, which has raised many interesting questions at various times in United States tax history. There is no occasion here for dispute. We have simply to deal with two different concepts, the economic and the legal, and must be on our guard only against the danger of confusion from the use of the same technical terms in two different senses.

The purpose of taxation. Of course the primary purpose of taxation is the raising of money whereby the government may pay the cost of performing its primary functions. While the discussion thus far has ignored any other purpose, it is essential to recognize that taxation may be imposed for other purposes and to examine the economic bearing of the more important of these purposes. The taxing power is among the most powerful and far-reaching of the attributes of sovereignty. Even when applied only for the purpose of securing government income, its indirect economic effects may be — indeed certainly will be — very great. When consciously used for the accomplishment of other ends its power can

scarcely be exaggerated. Taxation may be used to impoverish one individual and enrich another. It may foster or kill whole industries and destroy the prosperity of entire regions. It may divert the course of industry and trade, affect the movement and location of population, interfere with the distribution and consumption of wealth. With such a power in its hands, it is not surprising to find the government occasionally using it for the accomplishment of ulterior ends, nor is it strange that numerous programs of social reform through taxation are constantly being urged.

The most familiar illustration is the protective tariff. The tariff, or customs, is a tax, imposed originally and primarily for the sake of revenue. At various times and places it has been used for the purpose of checking the import of certain foreign products in order to relieve home producers of foreign competition and so to build up the home industries. This purpose has been so very prominent in the United States during most of its history that there may be a question whether protection is not really the primary purpose of the American tariff. Another example is the ten per cent tax imposed by the United States upon the notes of state banks. This tax was introduced with the sole purpose of legislating the state bank circulation out of existence. Revenue was not expected and has not appeared, since the tax has been successful in accomplishing its real purpose. Heavy license taxes imposed upon dealers selling alcoholic liquors are partly for the sake of revenue but also for the purpose of restricting and regulating the retail liquor establishments. Among suggestions for the use of taxation for "reform" are the proposal to limit or abolish roadside billboards by heavy taxes, the demand that inheritance taxes be used to produce a more equal distribution of wealth, and the time-honored "single tax" of Henry George.

In general it may be said that the use of a tax for another purpose tends to impair its effectiveness as a revenue machine. This is obviously true to the limit of such a tax as the prohibitory levy upon state bank notes, which produces no revenue at all, and it is especially applicable to the protective tariff. This subject will be pursued further in connection with our study of particular taxes, especially the tariff.

XXX

THE AMERICAN PROPERTY TAX

Evolution of the property tax. The possession of property furnishes so obvious a basis for the distribution of the costs of government or so obviously invites the exactions of the necessitous ruler, that it is not surprising to find that the property tax is among the oldest of taxes; history shows us numerous examples in ancient and medieval times. In those days and indeed for some centuries thereafter there did not exist the bewildering variety of different kinds of wealth and property rights which surround us at the present. Wealth consisted principally of lands and buildings; next in importance came domestic animals and agricultural tools and equipment; household furniture, clothing, and other forms of personal property were scarce and crude and, except in the homes of the kings and nobles, of little value. The earliest property taxes were generally imposed upon land and buildings. Later attempts to include various other forms of wealth and property rights as they gradually evolved did not prove successful, and the property tax in most European countries long ago returned essentially to its original base — real estate.

In America, on the contrary, where the property tax has since colonial days been the chief mainstay of state and local finance, the attempt is still generally made to include in its base most or at least very many of the complex modern forms of wealth and property rights. When thus inclusive, the tax is known as the *general property tax.*

Typical organization and operation in America. Being a subject of state law, the property tax is not carried out in exactly the same way in any two of the forty-eight states. However the general features of the tax present enough similarity to make it possible to construct a composite picture which will represent, not exactly the situation in any particular state, but rather the typical pro-

cedure which, with appropriate modifications, will conform closely enough to the situation in most of the states. The general property tax is provided by statute for the purpose of enabling the states and the counties, cities, towns or townships, and other local jurisdictions to secure the revenues necessary to their needs. The law determines what classes of property shall be taxable and what shall be exempt and prescribes a mass of administrative details. About the only legislative discretion left to the subordinate bodies is the power to fix the tax rates which shall be applied within their respective jurisdictions. On the other hand, the selection of assessors, collectors, and other administrative officers and the actual work of administration are almost wholly in the hands of either the towns or the counties, although there is a certain power of supervision and control lodged in the state tax commissioner or similar officer or board, the extent of which control varies greatly among the states.

Assessment. The first step in the operation of the property tax is the *assessment,* which means the discovery and valuation of all the taxable property of each person liable to the tax, as of a certain date each year specified in the statute. In some of the states assessment is the function of the towns; in the others it is performed by the counties. In this description we shall assume that the town has the matter in charge. The assessor must make out a "tax list" for each taxpayer, showing in more or less detail the description and value of all his taxable property. In some states the law requires the taxpayer to make out his own list and hand it to the assessor. In other states no list is required of the taxpayer, while in still others the taxpayer may be required to give certain information but not all, or he may have the option of filing a list or of having the list made by the assessor with an addition to the amount assessed as a penalty for failure to file the list. In every case however the final assessment is the work of the assessor, who is responsible for determining the total value of property to be assessed to each taxpayer. The law generally gives the assessor ample power to demand all necessary information from the taxpayer or from other witnesses.

Appeal, revision, and equalization. In each town there is a legally constituted body, known as the "board of relief" or by similar title,

whose function is to hear and settle appeals from any taxpayer who may feel that his property has been wrongly assessed. When this board has finished its work the tax lists, as corrected, are combined to form the "town list," which contains at the least a list of the names of all owners of taxable property in the town with the total value of the property assessed against each.

Each town then reports the total amount of its tax list to a county board, commonly called the "board of equalization." The principal duty of this board is to determine after investigation whether the assessment in the several towns in its jurisdiction has been performed according to law, particularly whether the total value of property as assessed is equal to the full true value in each town. The board may arbitrarily increase or decrease the valuation of any town in order to make it equal to the full value, or at least to make the ratio between assessed and true value the same in all the towns. The chief reason for this equalization is that, as will presently appear, the county tax is to be apportioned among the towns in proportion to their respective tax lists, and any town which undervalues its taxable property or, more precisely, undervalues it in greater degree than the average of all the towns is thereby escaping a part of its share of the county tax and correspondingly burdening the other towns. Sometimes, though not usually, the county board of equalization may have authority to revise individual assessments.

Having corrected the lists of such towns as in its opinion require revision, the county board makes up its county tax list, which is a list of all the towns with the total assessed value of the property in each town. The total for the whole county is then reported to the "state board of equalization" or corresponding board or official. This board performs with respect to the several counties the same process of equalization as has just been performed by each county board with respect to its towns. The purpose also is similar; namely, to prevent evasion of part of its share of the state tax by any county through undervaluation of its taxable property. The final result, after the state board has made its revisions, is the state tax list, showing the total assessed value of property in the entire state as distributed among the several counties.

Apportionment. The tax rate. The next step is the *apportionment* of the tax. Each jurisdiction decides what amount of revenue it must obtain from the property tax; this amount divided by the total of the taxable property within its jurisdiction gives the *tax rate* for that particular unit. The tax rate applicable to any given taxpayer will be the sum of the rates of all the jurisdictions by which he is taxable. To make this concrete, let us assume an example. Suppose that the work of assessment in a certain state has been completed, showing a tax list for the whole state of $1,000,000,000, which is distributed among the several counties as follows: County A, $200,000,000, County B, $100,000,000, and the rest in the other counties. Consider now County A, whose tax list of $200,000,000 is the sum of the lists of Town *a*, $50,000,000, Town *b*, $5,000,000, and the several other towns making up the remaining $145,000,000. Let us take account also of one other town, Town *c*, located in County B and having a tax list of $10,000,000 which is of course included in the $100,000,000 list of that county. Now let it be assumed that the state decides to raise $2,000,000 from the general property tax; the necessary tax rate will be calculated by dividing this amount by the state tax list, thus: $\frac{2,000,000}{1,000,000,000} = 0.002$, which in ordinary tax parlance would be called "2 mills on the dollar" or simply "2 mills." In exactly this way each jurisdiction decides how much it must raise from the general property tax and then calculates its tax rate. Let the following be the assumed tax lists and amounts to be raised, with the resulting tax rates:

Jurisdiction	*Tax list*	*Amount to be raised*	*Tax rate*
State	$1,000,000,000	$2,000,000	2 mills
County A	200,000,000	200,000	1 mill
Town *a*	50,000,000	500,000	10 mills
Town *b*	5,000,000	100,000	20 mills
County B	100,000,000	200,000	2 mills
Town *c*	10,000,000	150,000	15 mills

We can now get back to the individual taxpayer. Suppose three individuals: M, living in Town *a*, N, in Town *b*, and P, in Town *c*, each having property assessed at $10,000. From M there will be collected the taxes of the state, County A, and Town *a*, to whom he must pay respectively 2 mills, 1 mill, and 10 mills upon each

dollar of his assessed valuation. His total tax will then be at the rate of 13 mills and will amount to $130. N will pay at the rate of 23 mills, being the sum of the rates of the state, County A, and Town *b*; his tax will be $230. P has a rate of 19 mills, made up of the rates of the state, County B, and Town *c*, his tax being $190.

Generally there will be other political bodies which, while having little or nothing to do with the administration of the tax, are permitted by law to collect a tax from the taxpayers within their geographical limits. Thus a borough is generally a part of a town which, being more thickly settled and having need for special town services not performed for the whole town, is permitted to vote for such special services, to be paid for by a borough tax at a sufficient rate as determined by the people of the borough or their proper officers. If for example the individual M in our previous illustration lived in such a borough within the Town *a* and the borough tax rate were 7 mills, his total tax would be at the rate of 20 mills and would amount to $200, whereas another resident of the town living outside the borough would pay only the 13 mill rate. The same situation arises in the case of cities, whenever the city is not coterminous with the town. The school districts are the most important and numerous of the minor taxing jurisdictions; they very commonly have independent authority to determine their school revenues and their district school tax rates. There are also fire districts, street lighting districts, road districts, and other examples of limited groups of the people who are organized for the sake of obtaining special government services with authority to tax themselves by adding their own rates to the general property tax.

Collection. The final act is the *collection* of the tax. Each taxpayer receives a tax bill, or formal notice of the amount of his total assessment, the tax rate, and the amount of the tax due from him. In some states each town and county and the state has its own collector, who sends out bills and collects the tax due. The taxpayer may thus receive two, three, or more separate tax bills and make as many separate payments. In other states one bill is sent out and the entire tax is collected by the town or county collector, who then distributes its proper share to each jurisdiction concerned.

Modifications. The reader should again be reminded that the foregoing description is intended to be typical rather than descriptive of any particular state, and that a great number and variety of modifications is to be found. Equalization is in many states not performed by both county and state boards. There are certain states in which the state government has given up all share in the proceeds of the property tax and so has little or no interest in equalization. The process of apportionment is not always carried out in all the refinement here described, and in at least one state an entirely different method is employed. There are states in which certain of the tax rates are fixed by statute in advance of assessment, so that the assessment determines the amount of the yield. Such modifications in detail, of which these are only a few examples, are numerous enough but need not concern us here.

Position of the property tax. The tax whose practical machinery we have thus examined at some length is the main source of revenue of the states and local bodies of the United States. In the year 1932 according to the United States census [1] it produced for all the states and their subdivisions 4,685 million dollars, 53 per cent of their total revenue receipts of 8,852 millions. The reliance of the states and the several subordinate grades of government upon the property tax is clearly shown in the following table.[2]

	Total revenue receipts	*Property tax receipts*	
		Amount	Per Cent of Total
State governments	$2,208 mil.	$ 323 mil.	15
Counties	1,314 mil.	877 mil.	67
Cities, towns, villages, and boroughs	3,374 mil.	2,057 mil.	61
School districts	1,515 mil.	1,119 mil.	74
Townships	248 mil.	195 mil.	79
Other civil divisions	194 mil.	112 mil.	58
Total	$8,852 mil.	$4,685 mil.	53

[1] *Financial Statistics of State and Local Governments, 1932*, 1935, p. 7.

[2] *Ibid.*, pp. 4 and 7. See also the following reports of the National Industrial Conference Board: *Taxation and National Income*, 1922; *Tax Burdens and Exemptions*, 1923; *Tax Burdens and Public Expenditures*, 1926; *Cost of Government in the United States, 1929–1930*, 1932, and *Cost of Government, 1923–1934*, 1934; also reports of the United States Bureau of the Census upon financial statistics of states and of cities.

The total tax bill of the American people (to all grades of government, federal, state, and local) in 1932 was 8,147 million dollars. 1,786 millions of this were collected by the federal government. The property tax therefore produced two and a half times the amount of all taxes levied by the federal government and accounted for more than half the total national tax bill.[1] There can be no question of the predominant position of the property tax in American public finance or of the importance of its efficient operation.

Definitions. This is an appropriate place to define certain technical terms commonly used in property tax discussions. *Real estate* means in general (1) land (in its broadest sense), (2) all buildings and other structures permanently attached to the land, and (3) such equipment, machinery, etc., as is so definitely attached to a building that it could not be removed to another location without serious impairment of its value or use, such as elevators, fire escapes, shafting for machinery, etc.

Personal estate or *personal property* or *personalty* means all possessions except real estate. Personal property is divided into two classes: (1) *tangible* personal property, being that which has a physical substance, such as machinery, household furniture, jewelry, etc., and (2) *intangible* personal property, which includes all other personalty; that is, abstract rights against wealth in the physical possession of others or against other persons, such as promissory notes, corporation stocks, bank deposits, etc. It will be noted that the word "property" is here somewhat loosely used in conflict with the economic definition of that term. Strictly speaking, intangible personal property alone deserves the title of "property"; the others — real estate and tangible personalty — are "wealth." In most discussions of taxation however the term "property" is broadened to include all physical wealth as well as abstract property rights, and this usage is so well-nigh universal that it is scarcely to be avoided. If we occasionally follow the popular usage, no harm will be done so long as the sense in which the word is used is clearly understood.

[1] This comparison with federal taxes is somewhat misleading, due to the fact that the federal tax revenues were abnormally low in 1932 on account of the depression. In 1931 the federal tax revenue was 2,717 million dollars. On the basis of this figure, the property tax produced about 70 per cent more than all federal taxes.

Assessment: Discovery of taxable property. The crucial point in the practical operation of any tax is the assessment. The general property tax requires that there be entered opposite the name of each person a list of his taxable possessions (which includes nearly everything that he owns), with a statement of the true market value of each item and of the total. This implies (1) the discovery of all such property by the assessor in the face of at least the passive resistance of the taxpayer, and (2) the process of valuation. As to the first, the task is easy enough in the case of land and buildings and the more bulky and less movable kinds of personal wealth, such as farm and factory machinery, farm animals, etc. But the task of locating other kinds of tangible personalty, such as jewelry, is far from easy. Even such property as household furniture, rugs, books, pictures, clothing, etc., can be discovered only by a personal search of the taxpayer's home, and although the tax assessor generally has the legal right — indeed the obligation — of such search, he is loath to resort to it in the face of the natural repugnance of the taxpayer. House-to-house search for personal property is today the exception, not the rule, in tax assessment. If it were the rule, it is safe to say that a considerable amount of the more valuable and easily movable articles would be spirited away and concealed on tax day.

When we come to intangible property, difficulty of discovery becomes practical impossibility. Bonds, notes, stocks, bank deposits, and similar classes of property are readily concealed in bank vaults or in the taxpayer's office or home or if necessary may be actually removed into another town or state over tax day. The assessor is powerless, and the best he can do is to accept such information as is volunteered by the more conscientious taxpayers or to make a pure guess at the amount of such property and trust to the taxpayer to protest in case he has overshot the mark. Intangible property such as real estate mortgages, which must be publicly recorded, is discoverable, but this is no help when the mortgaged property is located and the mortgage recorded in another jurisdiction from that of the taxpayer's residence and tax obligation, since the assessors can hardly be expected to search the records of other towns or counties. Moreover most states exempt mortgages

upon real estate within the state, thus removing the only ones that could easily be discovered.

Practical problems of valuation. The state laws differ as to language, but in general they require that all property be assessed at its true market value, or words to that effect, sometimes specifying that it must be the value at which the property would be sold by a willing seller to a willing buyer, seeking quite properly to exclude the evidence of forced or otherwise unrepresentative sales. Tax legislation thus agrees closely with the economic concept of value.

Now except at the very time of a sale, the value at which anything "would sell" — in short its *value* — is a matter of judgment. It must be determined by an appraisal, which is just what assessment really is. Anyone acquainted with practical affairs has an idea of what is meant by appraisal. He knows that it can be accomplished only by an expert in the particular kind of property involved who is in possession of all the pertinent facts. Land appraisals are made for business purposes by real estate experts, who first gather carefully all available evidence and then give ample time to the study of the problem. They are usually assured of the coöperation of the owner or of someone else practically interested in the matter. The appraisal of a large apartment house or office building or factory is a difficult technical matter, which only the specialized expert can handle. And here again, when we pass from real estate to personalty, we pass from the difficult to the more difficult. The appraisal of the machinery in a cotton mill, of the raw materials, the "goods in process," and the finished products of a brass factory, the stock in trade — "inventory" — of a dry-goods store is each a complicated, time-consuming task for the man especially equipped for that particular appraisal. If it is instead a silk factory or a hardware store, another set of experts will be required. Such appraisals are constantly being made in practical business, for insurance companies, banks, investors, brokers, and for the manufacturers and merchants themselves. To be accomplished with the accuracy demanded for business purposes, they require the careful labors of specialized technical experts, highly trained and experienced.

Theoretical questions. Furthermore there are theoretical problems of valuation which are not solved merely by employing the right experts. How for example shall we assess the partly finished "goods in process" of a manufacturing plant? The manufacturer has his own methods for inventory purposes, based upon more or less arbitrary accounting rules; he may take cost of raw materials, add direct labor cost, put in something for "overhead," etc. But, except as an accounting fiction, the "value" thus obtained means little; it is to be doubted if it is really value at all. Who would buy the partly finished goods of most factories? Certainly it is questionable whether a "value" thus obtained is the true market value prescribed by the tax law. And if this is not the legal tax value, what in the world is? Another accounting rule is "cost less depreciation." But if there is no one likely to want to buy the article, can we accept the results of such a "valuation"? What for example should be the method of assessing special tools or patterns made and used in a factory on a particular job which is now completed? These are merely a few samples of some of the theoretical and technical questions which may well puzzle even the expert appraiser or the lawyer.

The assessor and his job: Expert assessment. The foregoing description of the assessment process will suggest that here is a difficult technical task, one that would clearly appear to require for its successful accomplishment a personnel of trained expert appraisers equipped with adequate organization and staff.

These requirements are met, more or less adequately, in a number of the larger cities and in some small cities. A staff of trained assessors, with the necessary clerical and other assistance, is built up. The work is so arranged as to continue through the year, permitting of long term or permanent employment, and giving to the assessor a steady "career" job, with adequate salary. Accurate maps of the entire region are made and skilfully used. Complete descriptive data regarding land and buildings are prepared and recorded. Evidence regarding all sales is gathered. Scientific rules for determining values with respect to location and various other standards are used. Even the aeroplane is pressed into service for the quick mapping of extended areas in the suburbs or country districts. In

many an American city, where such conditions prevail, a high degree of efficiency, in the assessment of land and buildings at least, has been attained.

Some of the states have obtained a certain degree of centralization of the work of assessment in the office of a state tax commissioner or board, which has enabled them to secure full-time services of engineers and other experts to aid in the work of local assessment.

The ordinary local assessment: General situation. But in spite of assistance now and then from the state tax commission, assessment is still essentially a local function, and the ordinary town or county or small city will seldom have anything like an adequate assessment organization or procedure. There is not enough work to warrant a full-time job with attractive salary. Expert qualifications cannot be and are not required of the candidate for the assessor's job. Let us picture for a moment the typical town assessor as he enters a great factory devoted to the manufacture, let us say, of clocks and watches, with millions of dollars' worth of land, water power, factory buildings, machinery and equipment, raw materials, goods in process, finished products, not to mention such intangible property as patents, contracts, "good-will," investments of various sorts, and so on. An appraisal of this plant and property may have been recently made for the owners or for a syndicate of bankers interested, which took weeks or months of labor by a corps of experts and cost hundreds or thousands of dollars. The assessor, if not the only one in the town, is one of two or three or half a dozen. He is perhaps a farmer or a carpenter; he was never in a watch factory before, never saw or even heard of many of the kinds of wealth before him. This factory is simply one of hundreds or thousands of properties which he must assess in the space of two or three months at most. He cannot take the time even to glance at all the items of wealth here assembled. Yet he is the one who is required by law to put a value upon this complicated assembly of wealth and property, which shall in large measure determine the amount of the contribution of its owners toward the cost of the town, county, and state governments.

It should be recognized that all assessments are not so complicated and so far above the heads of the assessors. The local assessor

in an agricultural town or a small village, himself a farmer or carpenter or blacksmith, gets on after a fashion in the assessment of farm lands, buildings, and equipment, and the simple homes and personal effects of the village. Even the stock in trade of the country store may be fairly within his ken, and he may not come up against the really difficult problems. But let no one delude himself with the thought that even this simple kind of assessment is as a rule well done; the facts are to the contrary. And it is the exceptional town which does not contain some examples of taxable property that will put to rout the equipment of any ordinary assessor.

Information from the owner. It may be asked: why not compel the owner to give the assessor the advantage of the results of his own appraisal or inventory or accounts; or does not the law in fact now give the assessor power to demand such information from the taxpayer? The answer is that, the tax assessor being unable to check the accuracy of such reports, reliance upon them would result in a system of self-assessment. Since even the most expert appraisal is a matter of judgment, and since there is the greatest variety in accounting practice, errors and inequalities would be inevitable, even assuming an honest intention on the taxpayer's part to make a truthful return. On the other hand, with the strongest of motives and almost unlimited opportunity, the probability of false statements and dishonest collusion is too great to be ignored. American tax practice has never fully accepted the principle of self-assessment, and while a very considerable amount of information is required of the taxpayer by the law, the ultimate obligation of the assessor to view and value the taxable property is seldom waived. Furthermore the very natural disinclination of the taxpayer to disclose to any outsider the intimate details of his personal possessions or the technical facts of his business is so strong that it has generally resisted successfully the assessor's efforts to secure complete information.

The attitude of the taxpayer. Under such conditions and with human nature as it is, the assessor can hardly expect much help from the taxpayers. There are those indeed — and their number is surprisingly large — who conscientiously try to pay all that the law

requires, even though there be little to compel it. Such persons are rewarded for their extreme honesty by bearing a burden of taxation out of all proportion to that borne by the rest of the community. The majority take the attitude of passive resistance: "Let's see you get it if you can." And a few use every means, fair and foul, to evade as much of their tax burden as is possible. So general is the cynical acceptance of this situation that the majority of honest, law-abiding citizens regularly once a year take oath to tax lists which they know perfectly are false on their face, and if any taxpayer was ever prosecuted for this open perjury we have not yet heard of the case.

How the assessor meets the situation. Under such circumstances as these, we need not be greatly surprised at the result. The assessor generally does about the best he can. In the first place, he has last year's lists, of which he takes full advantage; copying last year's figures will suffice for the majority of cases where he has reason to believe there has been no material change. He will travel over his district, making brief inspections of the outside of new buildings, casting cursory glances at the merchants' shelves, asking a few questions, picking up what gossip he can as to the worldly goods of his fellow townsmen. Using such information as this, reinforced by a good deal of often shrewd guesswork, influenced almost always by the popular satisfaction which will follow when everybody feels that he has been assessed considerably under true value, influenced now and then no doubt by the desire to be kind to a friend and to stand well with those of political and social influence, seldom downright corrupt, the assessor manages somehow to check up on the lists handed in by taxpayers, to make out the lists of those who fail to file them, and finally to turn in a town tax list which will not cause too many appeals to the board of relief, nor be too much censured by the county or state board of equalization, nor cause so much local dissatisfaction as to threaten his reëlection.

Results of assessment. With all the circumstances as thus pictured, we should hardly expect to find a true and faithful assessment of all taxable property, and the facts will fully justify our surmise. For reasons which are now obvious, the assessment of real estate is more effective than that of personal property. Yet figures collected

by the United States Census, going as far back as 1890, show that the assessed value of real estate all over the country is not more than half the true value legally taxable. These figures are confirmed by investigations by state tax commissions in various states and by numerous tax students. And while on the average real estate gets onto the tax lists at not more than half its true amount and value, this gives no adequate picture of the extreme variation among individual properties, which are assessed all the way from zero (when the property is not on the tax list at all) to 100 per cent of the value or even more. A careful investigation made in 1922 by the Connecticut State Tax Commissioner [1] showed in one small Connecticut town no item of real estate assessed at more than 40 per cent of its estimated true value, while the lowest was 9.2 per cent, and the average of all the cases investigated was 24 per cent. In another town, somewhat larger, the percentages of assessed to true value ranged all the way from 41 per cent to 106 per cent and the average for the thirty cases investigated was 76 per cent. Note not only the extraordinary variation among particular assessments but the great discrepancy between the two towns. For the whole state the average ratio of assessed to true value of real estate was probably not over 60 per cent. There is similar evidence from other states and no reason to believe that any state would show conditions much better.

When we examine the results of similar investigations of the assessment of personal property, the figures are either appalling or ridiculous according to one's state of mind. The United States Census, beginning with 1890, finds that less than 20 per cent of the true value of taxable personalty gets on the tax lists. As far back as 1870 a New York state commission estimated the ratio at 15 per cent in New York. There is every reason to believe that the breakdown is becoming more complete from year to year. A special investigation conducted by the Connecticut State Chamber of Commerce in 1916 [2] showed the following results as regards the assessment of personal property upon the farms of the state: only

[1] *Report of the Tax Commissioner* (of Connecticut), for 1921 and 1922, pp. 6–16.

[2] *Report of the Joint Committee on Taxation and State Finance to the State Chamber of Commerce*, 1917, pp. 12–18.

55 per cent of the true value of cattle was listed for taxation, 17 per cent of the cattle being not assessed at all; of sheep, goats, swine, and poultry less than 24 per cent of the true value was assessed; 41 per cent of the true value of horses and mules was reached; the assessed value of farm machinery was 6 per cent of its true value. And it must be remembered that these are among the classes of personal property most readily discoverable and most easy to value. Investigations into the assessment of household furniture, books and libraries, musical instruments, watches and jewelry, and other such classes of personal property demonstrate the almost complete escape of such possessions. And finally, when we come to intangible personal property, the value actually assessed is nowhere more than a trifling fraction of the amount of such property in existence and legally taxable. It is no exaggeration to say that the escape of intangible personal property throughout the United States is almost complete and that in most parts of the country the assessment of important classes of tangible personalty is either a ridiculous failure or has been virtually abandoned.

Undervaluation and high tax rates. Certain collateral results of imperfect assessment are of special importance. Consider the relation between prevailing undervaluation and property tax rates. Assessed values are almost everywhere below true values; sometimes by a moderate margin, sometimes so far that they are only a small fraction of the real value. Assessments at 20 per cent, 15 per cent, 10 per cent of true value or even less are no curiosities. There are two reasons. First is the natural desire of almost every taxpayer to get his own property in at the lowest possible value, in order that he may gain at the expense of his neighbors. In the second place is the common interest of the whole town in a low scale of assessments, since thereby the town reduces its share of the apportioned county and state taxes. Each taxpayer is therefore glad to have all assessments low and would in addition like to see his own at least a little lower than the average. Such universal pressure is too much for the average assessor, generally owing his position to the votes of the taxpayers.

Of course as certain classes of taxable property escape in whole or in part from the general property tax, either through failure to be

listed at all or through undervaluation, the burden upon other forms of wealth which are more effectively reached is correspondingly increased. The states, counties, and towns must have their necessary revenues, and as the tax base is narrowed by concealment and undervaluation, the tax rates have to rise. Tax rates have been going up steadily all over the United States, virtually since the beginning. Rates of 20 mills, 30 mills, 40 mills are common; 80 and 90 mill rates are not unknown. Such rates mean confiscation except when tempered by undervaluation. Undervaluation is the rule for most kinds of tangible wealth, real and personal, but for many kinds of intangible property undervaluation is hardly possible. If the assessor discovers a $10,000 mortgage at a good rate of interest upon adequate security he can scarcely enter it on the tax list at any other value with that figure staring him in the face. Corporation stocks and bonds, regularly quoted in the market reports, can hardly be entered at anything but their true market values. Now a tax at the rate of 2 per cent to 4 per cent upon a 4 per cent bond means anywhere from taking half the value to complete confiscation. This will be resisted by any intelligent taxpayer whose conscience is not quite quixotic and will indeed make the assessor himself hestitate; intangible property is virtually forced whenever possible to escape by means of concealment. We have a vicious circle; the higher the rates the more complete will be the evasion of all property which can possibly escape, and the more property succeeds in escaping the higher will the rates have to be on that which is left. Such property as cannot escape assessment is able to endure prevailing tax rates only because of prevailing undervaluation, and thus low valuations and high tax rates pursue each other about another vicious circle. Real estate has thus come to bear the bulk of the tax burden; at least four-fifths — probably more — of the property assessed consists of real estate.

Inequality and the legal remedy. With complete escape of certain kinds of property the regular thing, with gross undervaluation the general rule for all property that cannot escape, with tax rates so high as to be unendurable except when accompanied by undervaluation, with variation in individual assessments all the way from complete escape to more than 100 per cent of true value, necessity

of demonstrating serious inequality among the several taxpayers scarcely exists. We can safely let it go at that, and proceed to inquire as to the operation of the legal machinery for relief.

Any taxpayer who feels himself unjustly treated in the assessment of his own property may present his complaint before the local board of review. But except in the few cases where there is actual assessment at more than the true value, this generally avails him nothing. If in a town where property is assessed on the average at 40 per cent of true value, a certain taxpayer is assessed at 80 per cent, it is obvious enough that he is unjustly treated. But all he can prove to the board of relief is that his property, even so, is assessed 20 per cent less than the law requires. There have been a few cases in which the courts have required reduction of a particular assessment to agree with the general practice, but since proof of a general practice usually requires bringing evidence as to the true value of taxable property of every other taxpayer, or the majority of taxpayers, this remedy is seldom effective. Justice by legal review can be fully effective only when the millennium of full value assessment shall have been reached.

The attempt to give administrative relief for wholesale inequality caused by general undervaluation by towns and counties is equally ineffective. The county board of equalization has usually no possible way of determining the true value of taxable property in each of the towns. The most it can do is to gather evidence as to a few particular assessments, listen to the gossip that is current, and mainly by guesswork raise this town and lower that in the hope of diminishing some of the most glaring inequalities. The review of the state board of equalization is equally ineffective, though there are a few states in which a competent tax commission, armed with authority to revise original assessments in the towns, has been able to accomplish some good.

Confusing wealth and property. Some of the most serious difficulties of the property tax arise out of a fundamental defect in the very nature of the general property tax idea; namely, confusion between the concepts of wealth and property. If all physical wealth were taxed and in addition all the property rights to wealth, there would be no injustice, since wealth and property rights to wealth

are coterminous; there would simply be an unnecessary duplication of taxes where one tax, on either wealth or property at double the rate, would accomplish the same result. But many forms of property have no legal document to represent them and hence do not come within the purview of the tax laws. The result is that our laws usually attempt to tax *all* forms of physical wealth (barring the special exemptions) and in addition *some* classes of property rights. For example A and B are merchants, each owning a store and fixtures and stock in trade assessed at $100,000. A incorporates his business, the entire capital stock being owned by himself and members of his family. Now if, as many states require, his corporation is taxed upon the store and fixtures and goods assessed at $100,000, while he is taxed upon $100,000 of capital stock in the corporation, his tax is twice as much as it was before and twice as much as B's tax, with absolutely no difference in taxpaying ability. This is double taxation of the crudest sort. The same thing results when the holder of a mortgage or promissory note or other credit is taxed upon it, while the debtor is taxed upon the entire value of his possessions without deduction of the amount of the debt.

The present attitude of American state tax laws on this matter may be roughly summarized as follows: (1) shares of stock of domestic corporations are taxable to resident owners in somewhat less than half the states; shares of foreign corporations are similarly taxable in somewhat more than half the states; (2) bonds of corporations, whether domestic or foreign, are taxable to resident owners in about three-fourths of the states; (3) mortgages are generally exempt; when secured by property within the state, nearly all the states grant exemption, and a large majority exempt even mortgages secured by outside property.[1]

Modifications in detail. Attention should be called to certain adjustments in detail which have served somewhat to improve the operation of the general property tax. In some states the state has withdrawn from participation in the revenue from the tax, thus removing one cause of undervaluation. But if county apportionment continues, the improvement is not great, and there may be

[1] Cf. National Industrial Conference Board, *State and Local Taxation of Property*, 1930.

actual loss through withdrawal of state supervision and control. The state of Connecticut has solved this problem in the one effective way by apportioning the state tax, not upon the assessed value of property in the towns, but upon the respective amounts raised by the property tax.[1] Since reduced assessments must be accompanied by higher local tax rates in order that the town may secure its own revenue (the product of assessment by tax rate), the town has nothing to gain by undervaluation so far as the state tax upon the town is concerned.

Recognition of the peculiar position of intangible property, which has been pointed out, has led a number of states to provide for the taxation of such property at rates much lower than those applied to tangible wealth. It has been the hope that the taxpayers when granted a reasonable rate would voluntarily list their intangibles, and the experience of several states has shown a material increase in the amount of such property assessed following a reduction in the rate. There is no evidence however to show that any state has by this expedient succeeded in assessing the whole or even the greater part of the intangible property subject to its tax laws, and there is considerable evidence to show that the low-rate remedy gives at best only a slight mitigation of the former evasion.

Reform of the property tax. Adequate treatment of the topic indicated by this title cannot be compressed within the limits of a general text such as the present. A few suggestions only will be offered. Reform of the *general* property tax is not possible; only by relinquishing the idea of a general property tax can relief be expected. The first step is certainly the abandonment of all taxation of intangible personal property. This is indicated both by the theoretical nature of intangible property rights and by the complete and inevitable breakdown in administration. This step has been recommended by numerous tax authorities, including a committee of the National Tax Association, and it has been practically accomplished by the State of New York.

Next in order is the abandonment of the attempt to tax all those classes of tangible personalty where experience has shown the prac-

[1] Connecticut has unfortunately continued to reward undervaluation by certain grants of state moneys to the towns with low tax lists.

tical impossibility of a real assessment. This would include household furniture, private libraries, musical instruments, clothing and jewelry, and similar objects of essentially personal or domestic character. We may as well admit that these classes of property never have been and never will be properly assessed and give up attempting the impossible.

A special problem is presented by machinery and goods and materials of manufacturers and merchants. We have the choice of either giving up the taxation of such goods, as has been done by New York, or consigning their assessment to the state tax commission, with authority to use when necessary specified rules of assessment which do not necessarily arrive at market value. For example it would frequently be practicable to use methods such as are employed by the professional accountants in valuing these classes of business equipment and materials, basing estimates upon cost of replacement less depreciation, or upon cost of raw materials plus cost of labor in fabricating them. Safeguards should be provided however in order to prevent too wide departure from the fundamental standard of the value of the taxed wealth. This second remedy has recently been recommended by a special tax commission in Connecticut.[1]

These changes as to personal property would leave for assessment by the local assessors only real estate and a few forms of bulky, easily discovered, and easily valued tangible personal property. What should be substituted in order to reach the taxpaying ability possibly represented by the classes of tangible property exempted is not so serious a question as might at first appear. The fact is that, since the classes of property which it is proposed to exempt are the ones which now generally escape and which yield comparatively little revenue, the loss of revenue to be made up from this reform is not great. No substitute for household furniture, etc., is necessary. The amount of such property bears a fairly close relation to the value of the homes, and the microscopic increase in the tax rate on real estate that would suffice to make good the lost revenue would cause no injustice. As to industrial machinery and goods and

[1] *Report of the Connecticut Temporary Commission to Study the Tax Laws of the State and to Make Recommendations concerning Their Revision*, 1934, Chap. X.

materials of manufacturers and merchants, in case such wealth is to be removed from the property tax, some form of business income tax offers a practicable substitute. Thus New York increased her tax on the net income of business corporations in lieu of the tax on their personal property.

We must still take account of the fact that the present assessment even of real estate is far from perfect. Here however the task is not inherently impossible, and there is reasonable hope for improvement, once the assessors are relieved of the obligation to do the impossible and are allowed to concentrate their efforts upon that which can be done. As already suggested, there are certain cities whose assessment of lands and buildings has attained a high degree of efficiency. Similar results are possible in any city, town, or county where the finances are on a large enough scale to warrant the expense, and for the smaller and less wealthy towns and counties a consolidation of the work of assessment in the hands of larger units or groups of units is possible. While the work of assessing real estate may never be so organized as to produce perfect results, there is no reason why any state should not provide assessment machinery accurate enough to accomplish its purpose; *i.e.*, the equitable distribution of the cost of government.

A certain degree of centralization of administrative authority in the hands of a state officer or board is a great help in the task of assessment. This has been obtained in some states, with beneficial results. It makes possible the employment of technical experts whom most towns and counties cannot afford. Statistical data, rules of appraisal, and assistance of various sorts may be furnished the local assessors, and the authority of the state may be exerted to compel more efficient work on the part of local officials.

Any reform of the property tax requires that assessment be on the basis of the full market value of all taxable wealth and that tax rates be so low as to call for a reasonable, not a confiscatory, contribution from the owners. These two features go hand in hand. Assessed values cannot be brought up to 100 per cent if present high tax rates are to continue, and present rates cannot be materially reduced without increase of the tax base; on the other hand, either reform becomes possible if accompanied by the other. The

motive to undervaluation through the present method of apportioning state and county taxes must be abandoned; the substitute of the Connecticut method based on the tax revenue is a simple way out. When once the habit of full value assessment becomes established, review by a board of relief may be made to mean something, and an aggrieved taxpayer may have some real remedy.

Taxation of corporations. The taxation of corporations presents several special problems. In the first place, there is the complex problem of double taxation resulting from taxing both the corporations on their property and the owners on their stocks and bonds, to which reference has been made. Secondly it is the corporations which are the principal owners of those complicated categories of property whose valuation proves too much for the ordinary town or county assessors. In the third place, the wealth of many great corporations is located in more than one taxing district, being spread over several towns or counties or even states. The property cannot be assessed piecemeal, and no assessor has authority to assess the whole. This situation is peculiarly evident in the case of the railroads, telephone and telegraph companies, and other public service companies. These problems have been met in many states by taking the assessment from the local bodies and entrusting it to a state commission. In addition special methods are frequently applied, very generally to the public utility corporations and the banks and less commonly to the general business corporations.

Conclusion. The property tax, with all its defects, is still the backbone of the American tax system. In spite of the development of various other forms of taxation, which have permitted many of the states to reduce their reliance upon this tax, the property tax still contributes approximately half of the total tax revenue of the nation, including all grades of government. Indeed it is the property tax which, during the years of depression since 1929, has proved the anchor to windward that has saved American public finance from a vastly greater shipwreck than it has actually suffered. The relative contribution of the property tax, as compared with other taxes, has materially increased during the depression.

On the other hand, the property tax, as it exists in most of the states, is characterized by glaring defects which cause serious

inequality and injustice in the distribution of its burden. These defects have been sufficient to lead many students to desire and predict the decline and final passing of the property tax. Such predictions have not been fulfilled, and are not likely to be. The property tax has maintained itself because of its absolutely essential contribution to the cost of government. This however should not blind our eyes to the injustice which it perpetrates. Fortunately the defects of the property tax are not incapable of remedy, along lines which have been pointed out. Progress is moving, with some considerable rapidity, in this direction. America is probably destined to follow the European example in giving up the fiction of a *general* property tax. Thereafter reforms which are practicable and readily discernible should make of the property tax, not merely an effective revenue producer, but also a defensible instrument for the equitable apportionment of the costs of government in the American states.

Shifting and incidence. The problems of the shifting and incidence of the property tax are so closely interwoven with the corresponding problems of the income tax that their discussion will be most conveniently taken up after our study of the income tax. This topic is therefore postponed to the close of the next chapter.

XXXI

THE INCOME TAX AND OTHER TAXES

The income tax: Historical background. Whereas the property tax is one of the oldest forms of taxation, the income tax is a modern tax. The first real income tax was introduced in England in the year 1798. It was intended as only a temporary measure, though it actually lasted until 1816. It was not until 1842 that England again turned to the income tax, but from that year this form of taxation has been a permanent part of the British revenue system. Italy adopted the income tax in 1864. In Germany the separate states introduced the income tax at various dates during the latter half of the nineteenth century. Japan fell into line in 1887. France did not make use of the income tax until just before the outbreak of the World War. In Germany the income tax was taken from the separate states and made a national tax in connection with the revolution after the World War. From its beginning the income tax has won recognition as an acceptable form of taxation, and it has grown steadily in importance, until today it is the backbone of the national tax systems in most of the leading nations of the world. In the United States the income tax was used by a considerable number of the states before the federal government took its first step in this field. Some state income tax laws were enacted between 1840 and 1850, and during the second half of the nineteenth century the number grew to sixteen. These laws all carried over enough of the administrative features of the general property tax to insure their complete failure. Assessment was based upon the personal declaration of the taxpayer, and administration was in the hands of local officers; by the end of the nineteenth century the breakdown was complete.

The federal government first made use of the income tax at the time of the Civil War. This was a war measure; its yield declined rapidly after the war, and it was repealed in 1872. In the year 1894 the national government made its second excursion into the

field of income taxation. This act was declared unconstitutional before it went into effect, upon grounds which we shall examine presently. It was not until 1913, following an amendment of the federal Constitution, that the income tax became a permanent part of the tax system of the United States government. About this time state income taxation also acquired a fresh lease on life, beginning with the Wisconsin law of 1911, a carefully drawn law providing for complete administration by state officials. It has been a distinct success. Since then some thirty states have enacted personal income tax laws, which, profiting by the experience of the earlier epoch, generally provide for such centralized state administration as to give them at least a fair chance of success. Among the more conspicuous examples are those of New York and Massachusetts. A few states also levy income taxes upon corporations only. Today the income tax is the principal tax of the federal government and a source of revenue, more or less important, in more than half of the states.

Income taxation and the United States Constitution: Before the sixteenth amendment. The federal income tax of 1894, though never in effect, raised constitutional questions which are of great importance to the student of American taxation. Congress is forbidden by the Constitution to levy any direct tax unless apportioned among the states according to their population. This prohibition is expressed in Article I, section 9, in the following language: "No capitation, or other direct, tax shall be laid, unless in proportion to the census or enumeration hereinbefore directed to be taken." This means for example that, if the population of state A is double that of state B, the contribution of the residents of state A under any direct tax must be double the amount contributed by the residents of state B. This proportion must hold regardless of the wealth or incomes of the people. It might happen, for example, that B was a wealthy state and A a poor state, so that while A's population was double B's, the wealth of its residents was half that of the residents of B. Then, to carry out the constitutional rule of apportionment, the rate of the tax on the wealth of the residents of state A would have to be four times the rate imposed in state B. This rule is so flagrantly unjust that Congress has never attempted to

collect any large amount by means of direct taxes, and since the Civil War no attempt to use direct taxes has been made. The constitutional rule is practically equivalent to a prohibition of direct taxation.

The opponents of the income tax of 1894 claimed that the income tax was a direct tax and that, since the law made no provision for its apportionment according to the constitutional rule, it was therefore unconstitutional. Now the income tax, as regards its economic character, is certainly a direct tax, in that its burden is normally borne by those on whom it is imposed and not shifted to others. But this was not the idea of a direct tax in the minds of the framers of the Constitution, who apparently were thinking only of land taxes and poll taxes. The income tax was accordingly considered an indirect tax, legally, and it was so held by the Supreme Court of the United States when this question was raised with regard to the Civil War income tax. In 1894 however the Court reversed its previous ruling and in the case of *Pollock* v. *Farmers' Loan and Trust Co.* (157 U. S. 429) held that the income tax was a direct tax, thus bringing the legal definition into practical harmony with the economic concept of direct taxation, though by means of a line of argument which will scarcely stand the test of economic analysis. Being a direct tax, the income tax of 1894 was of course unconstitutional since it was not apportioned among the states according to population. Such an apportionment, as we have seen, would have been intolerable. This decision thus practically deprived the federal government of the power to use the income tax.

The Sixteenth Amendment. However the popular demand for this form of taxation was so strong that the constitutional obstacle was not permitted much longer to continue. In 1909 Congress imposed a tax upon the incomes of corporations only, this tax by a twist of legal reasoning being regarded as an excise — hence an indirect tax — and so not requiring distribution according to the population of the states. At the same time Congress proposed an amendment to the Constitution, which was finally ratified by the requisite number of states and promulgated as of March 1, 1913. This amendment, without reopening the question of definition or altering the constitutional rule of apportionment for other direct

taxes, expressly gives to Congress the power to impose an income tax without the necessity of apportionment. The ratification of this amendment was immediately followed by the enactment of the income tax of 1913, which imposed a tax upon the incomes of individuals and corporations, absorbing the existing corporate income tax of 1909.

The present United States income tax:[1] **Individual incomes.** The law distinguishes between individuals, corporations, and partnerships. As to the first, all residents of the United States are in general subject to the tax upon all their taxable incomes. Non-residents are generally taxable upon income derived from sources in the United States. The tax is upon the *net income*, which as defined in the law is determined in the following manner: The taxpayer's *gross income* consists of all receipts except those specifically excluded by the law. The principal categories thus excluded are the proceeds of life insurance policies, gifts, bequests, interest on state and municipal obligations, and (to a certain limited extent) interest on United States bonds and notes. Items so excluded need not be reported at all in the taxpayer's return.[2] From the gross income the law permits certain *deductions*, which include the expenses necessary to obtain the gross income, together with taxes, interest, and certain losses and contributions. What remains after subtracting the deductions from the gross income is the *net income*.

The individual tax is in two parts, a *normal tax* and a *surtax*. Before calculating either tax, the taxpayer is permitted to subtract from his net income two *credits:* (1) a "personal exemption" of $1,000 for a single person or $2,500 for a married person or a single person who is head of a family (the combined personal exemption of a husband and wife may not exceed $2,500, which amount may be taken by either one or divided between them), and (2) a credit of $400 for each child under 18 years of age or each person incapable of self-support who is supported by the taxpayer. The remainder obtained by subtracting these credits from the net income is the "surtax net income."

[1] Federal revenue act of 1938.
[2] Certain tax-free interest is reported for information only.

To obtain the base subject to the normal tax, we start with the "surtax net income" and deduct therefrom the following two credits: (1) interest on such United States bonds as were included in the gross income, and interest on obligations of certain corporations organized as instrumentalities of the United States government (such as the Reconstruction Finance Corporation), and (2) the "earned income credit."

The last-named credit is allowed for the purpose of granting differential treatment in favor of earned income as against income from investments. From that part of the taxpayer's income which was earned there must be deducted any expenses incurred in earning such income. Certain arbitrary limits are then applied: if the taxpayer's net income is not more than $3,000, the entire net income is assumed to be earned, regardless of the source in the particular case, and if the net income is more than $3,000, at least $3,000 is assumed to be earned; earned net income in excess of $3,000 must be proved, and the total earned net income of any taxpayer is limited to $14,000, regardless of the source. These provisions obviously can result in only a very rough approximation to the actual earned net income in any given case. Ten per cent of the earned net income so determined is the "earned income credit." The remainder obtained by deducting these two credits (so far as applicable) from the "surtax net income" is the "balance subject to normal tax."

The rate of the normal tax is 4 per cent. As to the surtax, the first $4,000 of "surtax net income" is exempt; thereafter the rates are progressive from 4 per cent on the next $2,000 to 75 per cent on the excess of any income above $5,000,000.

An example. The important features of the individual income tax and the technical terms employed may be made clearer by a simple practical illustration. Let us take the case of a lawyer whose total receipts during the year 1938 consisted of: professional fees, $20,000, interest on bonds of the city of New York, $1,000, dividends from General Motors Corporation stock, $4,000, and a bequest of $10,000. He paid out during the year for professional expenses, $5,000, taxes, $1,000, and contributions, $1,000. He was married and had 4 children aged respectively 7, 10, 15, and 19 years.

It will be convenient to calculate first the "earned income credit." The net earned income in this case is evidently the $20,000 of fees less the professional expenses of $5,000, or $15,000. As this exceeds the maximum allowed as basis for the credit, we must take the statutory maximum, $14,000, as the net earned income. The credit is 10 per cent of this, or $1,400.

The tax for the year 1938 may now be determined by the following computation:

Professional fees,		$20,000	
Professional expenses,		5,000	
		15,000	
Dividends from General Motors Co.		4,000	
Total *gross income,*			$19,000
Taxes,		1,000	
Contributions,		1,000	
Total *deductions,*			2,000
Net income,			17,000
Personal exemption,		2,500	
Credit for 3 children,		1,200	
Total,			3,700
Balance (*surtax net income*),			13,300
Earned income credit,			1,400
Balance subject to normal tax,			11,900
Normal tax @ 4%,			476
Surtax:	on first $4,000	0	
	on next 2,000 @ 4%	80	
	on next 2,000 @ 5%	100	
	on next 2,000 @ 6%	120	
	on next 2,000 @ 7%	140	
	on last 1,300 @ 8%	104	
Total *surtax*	on 13,300		544
Total tax,			1,020

Incomes of corporations and partnerships. Corporations also (with certain exceptions) are taxed upon their net income. A corporation whose net income is not more than $25,000 pays a tax at rates ranging from 12½ per cent to 16 per cent according to the amount of the net income. A corporation with net income in excess of $25,000 pays a flat rate of 19 per cent with a credit of 2½ on the amount paid out in dividends. Corporations are subject also to a tax on capital stock and a tax on their "excess profits."